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Reporting on internal accounting control; Statement on auditing standards, 030

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Reporting on Internal Accounting Control

(Supersedes Statement on Auditing Standards No. 1, sections 640, "Reports on Internal Control," and 641, "Reports on Internal Control Based on Criteria Established by Governmental Agencies.")

1. This Statement describes the procedures an independent accountant should apply in connection with various types of engagements to report on an entity's system of internal accounting control, and it describes the different forms of the accountant's report to be issued in connection with such engagements.[1]

2. An independent accountant may be engaged to report on an entity's system of internal accounting control in several ways. The accountant may be engaged to

a. Express an opinion on the entity's system of internal accounting control in effect as of a specified date (paragraphs 3 through 46). (An accountant may also be engaged to express an opinion on the

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[1]The auditor's study and evaluation of internal accounting control in an examination of an entity's financial statements is discussed in SAS No. 1, section 320. The effects of the use of EDP on internal accounting control and on an auditor's study and evaluation thereof are discussed in SAS No. 3. The guidance in those Statements is generally applicable also to engagements to report on internal accounting control. This Statement provides (1) additional guidance concerning matters that are unique to engagements to report on internal accounting control and (2) a further discussion of certain related matters in section 320.
This Statement amends SAS No. 1, section 320.68 and SAS No. 20, paragraphs 1, 8, and 9. See the Appendix for the revised wording.

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entity's system of internal accounting control in effect during a specified period of time; in which case, the guidance in such paragraphs should be adapted as appropriate.)

b. Report on the entity's system, for the restricted use of management, specified regulatory agencies, or other specified third parties, based solely on a study and evaluation of internal accounting control made as part of an audit of the entity's financial statements that is not sufficient for expressing an opinion on the system (paragraphs 47 through 53).[2]

c. Report on all or part of an entity's system, for the restricted use of management or specified regulatory agencies, based on the regulatory agencies' pre-established criteria (paragraphs 54 through 59).

d. Issue other special-purpose reports on all or part of an entity's system for the restricted use of management, specified regulatory agencies, or other specified third parties (paragraphs 60 and 61).

An accountant may also be involved with an entity's system of internal accounting control in ways that do not involve reporting in accordance with this Statement. For example, an accountant may be engaged to consult on improving the system. In these circumstances the accountant may communicate the results of his engagement by letters, memoranda, and other less formal means solely for the internal information of management.

Expression of an Opinion on an Entity's System of Internal Accounting Control

3. This section describes the general considerations, the study and evaluation, and the form of the accountant's report applicable to an engagement to express an opinion on an entity's system of internal accounting control. The accountant does not need to place any restrictions on the use of this report.

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[2]As the terms are used in this Statement, *management* includes directors, officers, and others who perform managerial functions, and *regulatory agencies* include governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions.

General Considerations

The Objectives of Internal Accounting Control

4. The broad objectives of internal accounting control, as defined in SAS No. 1, section 320.28, are to provide management with reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition and that financial records are reliable to permit the preparation of financial statements. The definition also sets forth the following operative objectives that are necessary to achieve the broad objectives:

a. Transactions are executed in accordance with management's general or specific authorization.

b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.

c. Access to assets is permitted only in accordance with management's authorization.

d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

5. In the context of internal accounting controls, *safeguarding of assets* refers only to protection against loss arising from errors and irregularities in processing transactions and handling the related assets.[3] It does not include the loss of assets arising from management's operating business decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that later prove to be unnecessary or unsatisfactory, authorizing what turns out to be unproductive research or ineffective advertising, or accepting some level of customer pilferage of merchandise as part of operating a retail business.

6. The objective concerning the reliability of financial records relates to financial statements regularly released to users outside the entity. This would include annual financial statements, interim financial statements, and summarized financial data derived from such statements.

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[3]A note to section 320.36 of SAS No. 1 specifies that " 'errors' refers to unintentional mistakes, and 'irregularities' refers to intentional distortions of financial statements and to defalcations."

7. The preparation of financial statements requires the use of estimates and judgments, and internal accounting control includes controls relating to those estimates and judgments. The nature of such controls, however, differs from that of controls relating to the execution and recording of transactions and to the safeguarding of assets. Estimates and judgments are necessarily subjective and relate largely to future conditions and events; accordingly, internal accounting controls relating to estimates and judgments are limited to those procedures designed to provide reasonable assurance that individuals at appropriate levels in the organization review and consider sufficient, reliable information in making the required estimates and judgments.

Limitations

8. There are inherent limitations, discussed in SAS No. 1, section 320.34, that should be recognized in considering the potential effectiveness of any system of internal accounting control. Particularly significant for the purpose of reports on internal accounting control is "any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with prescribed procedures may deteriorate."

Relationship to the Study and Evaluation Made in an Audit

9. An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting controls made as part of an examination of financial statements in accordance with generally accepted auditing standards differ in purpose and generally differ in scope. While the former can be made in conjunction with the latter, an engagement to express an opinion on the system of internal accounting control can be made as of a different date or by a different accountant as long as the accountant obtains the necessary understanding of the entity's operations (see paragraph 14).

10. The purpose of an engagement to express an opinion on an entity's system of internal accounting control differs from the purpose of the study and evaluation of internal accounting controls made as part of an audit. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for determining the extent

to which auditing procedures are to be restricted and assists the auditor in planning and performing his examination. In an audit, the auditor may decide not to rely on prescribed control procedures because he concludes either (*a*) that the procedures are not satisfactory for his purposes or (*b*) that the audit effort required to test compliance with the procedures to justify reliance on them would exceed the reduction in effort that could be achieved by such reliance. Accordingly, the study and evaluation of the system of internal accounting control in an audit is generally more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control. Nevertheless, an accountant's opinion on a system of internal accounting control does not increase the reliability of financial statements that have been audited.

11. Although the scope of the study and evaluation of internal accounting controls in an engagement to express an opinion on the system of internal accounting control generally differs from that of an audit, the procedures are similar in nature. Thus, the study and evaluation made in connection with an engagement to express an opinion on the system may also serve as a basis for reliance on internal accounting controls in determining the nature, timing, and extent of audit tests. Furthermore, an accountant need not apply procedures in an audit that duplicate procedures that have been applied for the purpose of expressing an opinion on an entity's system of internal accounting control.

Relationship to the Foreign Corrupt Practices Act

12. The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for companies subject to the Securities Exchange Act of 1934. Whether a company is in compliance with those provisions of the FCPA is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions but may be helpful to management in evaluating the company's compliance.

The Study and Evaluation

13. In making a study and evaluation for the purpose of expressing an opinion on an entity's system of internal accounting control in effect as of a specified date, the accountant should (*a*) plan the scope

of the engagement, (*b*) review the design of the system, (*c*) test compliance with prescribed procedures, and (*d*) evaluate the results of his review and tests.

Planning the Scope of the Engagement

14. *General considerations.* Among the factors to be considered in planning the scope of the engagement are

a. The nature of the entity's operations, including the susceptibility of assets to unauthorized use or misappropriation in light of their mobility or salability and the nature and volume of transactions.

b. The overall control environment, including
   1. The entity's organizational structure, including the duties and authority of the board of directors and its audit committee (or comparable bodies), senior management, and management of subsidiaries, affiliates, divisions, or other operating units.
   2. The methods used to communicate responsibility and authority.
   3. The principal financial reports prepared for management planning and control purposes, such as budgets.
   4. Management's supervision of the system, including the internal audit function, if any.
   5. Competence of personnel.

c. The extent of recent changes, if any, in the entity, its operations, or its control procedures.

d. Relative significance of the various classes of transactions and related assets.

e. Knowledge obtained in auditing the entity's financial statements and in past engagements to express an opinion on the entity's system.

15. *Multiple locations.* For an entity with operations in several locations, the considerations involved in deciding the locations to study are similar to those involved in an audit. It may not be necessary to review and test the controls at each location. In addition to the factors listed in paragraph 14, the selection of locations to be visited should be based on factors such as (*a*) the similarity of business operations and control systems at different locations, (*b*) the degree of centralization of accounting records, (*c*) the effectiveness of the internal reporting system used by senior management to supervise activities at various locations, (*d*) the effectiveness of other supervisory activities,

such as an internal audit function, and (*e*) the nature and amount of transactions and related assets at the various locations.

16. *Internal audit.* Reviewing and testing the system of internal accounting control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent accountant's procedures. If the independent accountant will be considering or using the work of, or receiving direct assistance from, the entity's internal auditors, the accountant should follow the guidance in SAS No. 9 in considering their competence and objectivity and in evaluating their work.

17. *Documentation.* For the accountant to be able to report on the system of internal accounting control, the accountant and management should have a common understanding both of the specific control objectives appropriate to the circumstances and of the control procedures in effect that are designed to achieve those objectives. The specific control objectives and related procedures should be appropriately documented to serve as a basis for the accountant's report. The documentation of the system may take many forms: internal control manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or answers to questionnaires. No one particular form of documentation is necessary, and the extent of documentation will vary.

Reviewing the Design of the System

18. The purpose of the review of the design of the system is to obtain sufficient information to permit the accountant to reach a conclusion about whether the entity's control procedures are suitably designed to achieve the objectives of internal accounting control.[4] For this purpose the accountant should obtain an understanding of

a. The flow of transactions through the accounting system.

b. The specific control objectives that relate to points in the flow of transactions and handling of assets where errors or irregularities could occur.

c. The specific control procedures or techniques that the entity has established to achieve the specific control objectives.

[4]The "design" of the system refers to the plan of organization and the procedures and records that have been established.

19. *The flow of transactions.* The accounting system should be distinguished from the system of internal accounting control. While an accounting system may include procedures that contribute to achieving a control objective, its primary purpose is to process transactions. An accountant obtains an understanding of the accounting system to identify points in the processing of transactions and handling of assets where errors or irregularities may occur.

20. The accountant should obtain an understanding of the system for processing each significant class of transactions. The accountant should identify the classes of transactions processed and the related assets and, for each significant class, identify the flow of transactions from authorization through execution and recording of transactions and the accountability for the resulting assets. Transactions may be grouped in a variety of ways – for example, by cycles of business activity or by business functions.[5] Whatever approach is used, the accountant should identify each significant class of transactions and obtain an understanding of the flow of transactions. The accountant's procedures in obtaining such an understanding may include inspection of written documentation, inquiries of client personnel, and observation of the processing of transactions and the handling of the related assets.

21. *Specific control objectives.* Paragraph 4 lists the four operative objectives of internal accounting control. Those operative objectives need to be further refined into specific control objectives for the purpose of identifying and evaluating the controls over specific classes of transactions and related assets within an entity. The accountant should determine whether management has identified the specific control objectives relating to points in the processing of transactions and the handling of assets where errors or irregularities could occur. An example of a specific control objective in a revenue cycle is that all goods shipped are billed.

22. *Specific control procedures.* A system of internal accounting control should include specific control procedures designed to achieve the specific objectives of internal accounting control for each

[5]SAS No. 1, section 320.23 explains, "Execution of transactions includes the entire cycle of steps necessary to complete the exchange of assets between parties or the transfer or use of assets within the business. . . . For example, the typical sale would involve acceptance of an order, shipment and billing of the product, and collection of the billing."

significant class of transactions and related assets. The accountant should consider the effectiveness of the specific control procedures either individually or in combination, taking into consideration the overall control environment and other applicable considerations discussed in paragraph 14. The accountant should focus on procedures in terms of their significance to the achievement of specific objectives rather than consider the specific procedures in isolation. Thus, when one or more specific control procedures are adequate to achieve a specific objective, the accountant need not consider other procedures. Alternatively, the absence or the inadequacy of one specific control procedure designed to achieve a specific objective may not be a weakness if other specific control procedures achieve the same objective.

23. There are two general levels of control procedures: primary and secondary. Primary control procedures are designed to achieve one or more specific control objectives, and they generally are applied at points where errors or irregularities could occur in the processing of transactions and the handling of assets. Primary control procedures may be applied to transactions and assets individually or at various levels of summarization. Examples of primary control procedures are monthly reconciliations of bank accounts and systematic matching of receiving documents with vendor invoices, when these functions are performed by persons who have no incompatible duties.

24. Secondary control procedures include any administrative controls or other management functions that achieve, or contribute to the achievement of, specific control objectives and thus are comprehended in the definition of internal accounting control (SAS No. 1, section 320.12). Such procedures are designed primarily to achieve broader management objectives, and they are not a part of the processing of transactions and the handling of assets. Examples of secondary controls include the systematic comparison of recorded transactions and account balances with expected results based on such sources of information as budgets, standard costs, engineering estimates, prior experience, and management's personal knowledge of operations. The effectiveness of such comparisons for the purpose of deterring or detecting errors and irregularities depends on the reliability of the sources of information used and on the thoroughness of the investigation of variations from the expected results. Accordingly, careful consideration and judgment is required in evaluating the effectiveness of secondary controls.

Testing Compliance With Prescribed Procedures

25. The purpose of tests of compliance is to provide a basis for the accountant to reach a conclusion about whether the specific control procedures necessary for the achievement of specific control objectives are being applied as prescribed as of the specified date of his study and evaluation.

26. The nature and extent of the accountant's tests of compliance with prescribed procedures in an engagement to express an opinion on the system of internal accounting control involve essentially the same considerations as tests of compliance made as part of an audit. The nature, timing, and extent of the auditor's tests of compliance with those controls on which he relies in an audit are discussed in SAS No. 1, section 320.57 through .63.

27. In an engagement to express an opinion on a system as of a specified date, the period of time necessary for testing compliance varies with the nature of the controls being tested. Some control procedures may function continuously (for example, control procedures over sales), but other control procedures may operate only at certain times (for example, control procedures relating to the preparation of interim financial statements). In addition, some control procedures that function continuously may be used frequently (for example, control procedures over customer receivables), while others may be used less frequently (for example, control procedures over advances to employees). The accountant should test compliance with control procedures over a period that is adequate for him to determine whether the specific control procedures are being applied as prescribed as of the date specified in his report.

28. Management may change its system of internal accounting control to correct weaknesses in the existing system or to make it more efficient. The accountant does not need to consider the superseded controls. If the accountant determines that the new control procedures achieve the related specific objectives of internal accounting control and that the procedures have been in effect for a sufficient time to permit the accountant to test compliance with them, the accountant's review and testing of these procedures would not require any additional considerations.

Evaluating the Results of the Review of the Design of the System and Tests of Compliance

29. In evaluating a system of internal accounting control for the purpose of expressing an opinion on the system as a whole, the accountant should consider the results of his review of the design of the system and of his tests of compliance. For this purpose, the accountant should identify weaknesses in the system and evaluate whether they are material, either individually or in combination.

30. A weakness in internal accounting control is a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective—that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements (see paragraph 6).

31. In evaluating an individual weakness, the accountant should recognize that

a. The amounts of errors or irregularities that may occur and remain undetected range from zero to the gross amount of assets or transactions exposed to the weakness.

b. The risk or probability of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure may be very low, but the risk of smaller amounts may be progressively greater.

32. In evaluating the combined effect of individually immaterial weaknesses, the accountant should consider

a. The range or distribution of the amounts of errors or irregularities that may result during the same accounting period from two or more individual weaknesses.

b. The joint risk or probability that such a combination of errors or irregularities would be material.

33. The evaluation of identified weaknesses necessarily is a very subjective process that depends on such factors as the nature of the accounting process and of any assets exposed to the weaknesses, the

overall control environment, and the experience and judgment of those making the estimates. The accountant should consider, to the extent that it is applicable in the current conditions, any relevant historical data that are available or can reasonably be developed.

34. Historical data provide a more reasonable basis for estimating the risk of errors than they do for estimating the risk of irregularities. Errors are unintentional, and their underlying causes tend to result in a more recurring or predictable level of occurrence. Irregularities are intentional, and their underlying causes ordinarily involve a lack of integrity and a motivation for personal gain, which are less predictable from historical experience. Thus, the accountant should presume a high risk of irregularities if inadequate segregation of duties places an individual in a position to perpetrate and to conceal irregularities in the normal course of that person's duties.

Management's Written Representations

35. The accountant should ordinarily obtain management's written representations

a. Acknowledging management's responsibility for establishing and maintaining the system of internal accounting control.

b. Stating that management has disclosed to the accountant all material weaknesses in the system of which they are aware, including those for which management believes the cost of corrective action may exceed the benefits.

c. Describing any irregularities involving management or employees who have significant roles in the system of internal accounting control.

d. Stating whether there were any changes subsequent to the date being reported on that would significantly affect the system of internal accounting control, including any corrective action taken by management with regard to material weaknesses.

The Accountant's Working Papers

36. The extent to which the accountant documents the engagement to express an opinion on a system of internal accounting control is a matter of professional judgment. The judgment is similar to that made in connection with an audit. Documents prepared by the entity

to describe its system of internal accounting control may be used by the accountant in his working papers.

The Form of the Accountant's Report

37. An independent accountant may express an opinion on a system of internal accounting control of any entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, can be prepared.

38. The accountant's report expressing an opinion on an entity's system of internal accounting control should contain

a. A description of the scope of the engagement.

b. The date to which the opinion relates.

c. A statement that the establishment and maintenance of the system is the responsibility of management.

d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.

e. The accountant's opinion on whether the system taken as a whole was sufficient to meet the broad objectives of internal accounting control insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to financial statements.

The report should be dated as of the date of completion of field work and may be addressed to the entity whose system is being studied or to its board of directors or stockholders.

Standard Form of Report

39. The following language should be used to express an unqualified opinion on an entity's system of internal accounting control:

> We have made a study and evaluation of the system of internal accounting control of XYZ Company and subsidiaries in effect at (date). Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants.
>
> The management of XYZ Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling

this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the consolidated financial statements.

Reporting Material Weaknesses

40. If the study and evaluation discloses conditions that, individually or in combination, result in one or more material weaknesses, the opinion paragraph of the accountant's report (paragraph 39) should be modified as follows:

> Our study and evaluation disclosed the following conditions in the system of internal accounting control of XYZ Company and subsidiaries in effect at (date), which, in our opinion, result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements may occur and not be detected within a timely period.

The report should describe the material weaknesses, state whether they result from the absence of control procedures or the degree of compliance with them, and describe the general nature of potential errors or irregularities that may occur as a result of the weaknesses. The accountant may want to report to management other weaknesses even though they are not considered to be material (see paragraphs 51 through 53).

41. If a document that contains an accountant's opinion identifying a material weakness also includes a statement by management assert-

ing that the cost of correcting the weakness would exceed the benefits of reducing the risk of errors or irregularities, the accountant should not express any opinion as to management's statement.[6] However, the accountant is not precluded from disclaiming an opinion on any such statement.

42. If management has implemented control procedures to correct the weakness, the accountant should not refer to this corrective action unless he has satisfied himself that the procedures are suitably designed and are being applied as prescribed.

43. If the opinion on the internal accounting control system is issued in conjunction with an examination of the entity's financial statements, the following sentence should be included in the paragraph that describes the material weakness:

> These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the 19XX financial statements, and this report does not affect our report on these financial statements dated (date of report).

Scope Limitations

44. An unqualified opinion on an entity's system of internal accounting control can be expressed only if the accountant has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his engagement, whether imposed by the client or by the circumstances, may require the accountant to qualify or disclaim an opinion. The accountant's decision to qualify or disclaim an opinion because of a scope limitation depends on the accountant's assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the system of internal accounting control. When restrictions that significantly limit the scope of the study and evaluation are imposed by the client, the accountant generally should disclaim an opinion on the system of internal accounting control.

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[6] This is not intended to preclude an accountant from advising his client with respect to the practicability of specific control procedures that may be under consideration. However, as is the case in other matters involving advice by an accountant, it is the responsibility of management to make the decisions concerning costs to be incurred and related benefits.

Opinion Based in Part on the Report of Another Accountant

45. When an accountant decides to make reference to the report of another accountant as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other accountant in expressing his opinion. In these circumstances, the considerations are similar to those that arise when the independent auditor reporting on financial statements uses the work and reports of other independent auditors (see SAS No. 1, section 543).

Subsequent Information

46. The accountant has no responsibility to keep informed of events subsequent to the date of the report; however, the accountant may later become aware of conditions that existed at the date of the report that might have affected his opinion had he been aware of them. The accountant's consideration of such subsequent information is similar to an auditor's consideration of comparable information discovered subsequent to the date of his report on an audit of financial statements (see SAS No. 1, section 561).

Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit

47. As discussed earlier, the purpose and, generally, the scope of an independent accountant's engagement to express an opinion on an entity's system of internal accounting control differ from those of a study and evaluation of internal accounting control made in an examination of financial statements in accordance with generally accepted auditing standards.

48. Nevertheless, the auditor may be requested to report on internal accounting control based solely on the study and evaluation made in an audit of financial statements even though it is not sufficient for expressing an opinion on the system taken as a whole. The auditor may report in these circumstances, provided the report indicates that it is intended solely for management, a specified regulatory agency, or

other specified third party,[7] and that the report describes the limited purpose of the study and evaluation and disclaims an opinion on the system of internal accounting control taken as a whole.[8]

49. The following is an illustration of an auditor's report on internal accounting control when the study and evaluation made as part of the audit is not sufficient for expressing an opinion on the system taken as a whole.

To the Board of Directors of XYZ Company:

We have examined the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated February 23, 19X2.[9] As part of our examination, we made a study and evaluation of the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the company's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole.

The management of XYZ Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting

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[7]This form of reporting is appropriate, even though by law or regulation the accountant's report may be made a matter of public record.

[8]When the study and evaluation made as part of an audit is sufficient for expressing an opinion on the system, the auditor may report in accordance with paragraphs 37 through 46.

[9]If the report on an examination of the financial statements is qualified because of a restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report. If a portion of the examination has been performed by other auditors, the principal auditor's report should make it clear that it does not cover the entities examined by the other auditors. If the other auditors have issued a report concerning material weaknesses, the principal auditor may wish to, but is not required to, refer to such report of the other auditors.

control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of XYZ Company taken as a whole. However, our study and evaluation disclosed no condition that we believed to be a material weakness.

This report is intended solely for the use of management (or specified regulatory agency or other specified third party) and should not be used for any other purpose.

50. If the study and evaluation discloses material weaknesses (as defined in SAS No. 20, as amended), the report should describe the weaknesses that have come to the auditor's attention and state that they were considered in determining the audit tests to be applied in the examination of financial statements. The last sentence of the fourth paragraph of the illustrative report should be modified as follows:

However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of XYZ Company may occur and not be detected within a timely period. (A description of the material weaknesses that have come to the auditor's attention would follow.)

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on these financial statements dated (date of report).

51. The auditor may want to report other weaknesses even though they are not considered to be material. Comments on such weaknesses should be clearly distinguished from those relating to material weaknesses. If some weaknesses are reported to one group but not to another (for example, to management but not to regulatory agencies), the more extensive report should distinguish the weaknesses that are excluded from the other report, and the auditor should be prepared to support, if necessary, his judgment in making the distinction.

52. In some cases reports on internal accounting control may include comments on additional matters. For example, a regulatory agency may require comments on certain aspects of administrative

control or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph 49 should be modified to identify clearly the additional matters and distinguish them from internal accounting control, to describe in reasonable detail the scope of the review and tests concerning them, and to express conclusions in language comparable to that in paragraphs 49 and 50 as appropriate. The identification of the additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

53. Suggestions or other comments concerning specific aspects of internal accounting control and various other matters are often submitted to management by auditors as a result of observations made during their examinations of financial statements. These comments are often submitted by letters, memoranda, and other less formal means. This practice is encouraged, and this section is not intended to preclude the use of such means of communication.

Reports Based on Criteria Established by Regulatory Agencies

54. Some governmental or other agencies that exercise regulatory, supervisory, or other public administrative functions may require reports on internal accounting controls of organizations subject to their regulations. A report on internal accounting control in the form illustrated in paragraphs 39 or 49 may be acceptable to such an agency; however, an agency may set forth specific criteria for the evaluation of the adequacy of internal accounting control procedures for their purposes and may require a report based on those criteria.

55. Criteria established by an agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of internal accounting control and may also encompass specified aspects of administrative control or of compliance with grants, regulations, or statutes. For the accountant to be able to issue the report described in paragraph 56, the criteria should

be in reasonable detail and in terms susceptible to objective application.[10]

56. The accountant's report should (*a*) clearly identify the matters covered by his study,[11] (*b*) indicate whether the study included tests of compliance with the procedures covered by his study, (*c*) describe the objectives and limitations of internal accounting control and of accountants' evaluations of it, (*d*) state the accountant's conclusions, based on the agency's criteria, concerning the adequacy of the procedures studied, with an exception regarding any material weaknesses, and (*e*) state that it is intended for use in connection with the grant or other purpose to which the report refers and that it should not be used for any other purpose.[12] If the agency requires the accountant to report on all conditions (whether material or not) that are not in conformity with the agency's criteria, the accountant should do so. If the agency does not require the accountant to report on conditions that are not material, he may do so, and he may also include recommendations for corrective action or describe corrective actions taken by the organization (see paragraph 42).

57. For the purpose of these reports, a material weakness includes either (*a*) a condition that results in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions or (*b*) a condition in which the lack of conformity with the agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

58. When the accountant issues this form of report, he does not assume any responsibility for the comprehensiveness of the criteria established by the agency; however, he should report any relevant condition that comes to his attention in the course of his study that he believes to be a material weakness, even though it is not covered by such criteria.

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[10]Also, an agency may require a report on the design of an internal accounting control system before the organization has started operations.

[11]This can be accomplished by reference to the publication in which the established criteria are set forth.

[12]This form of reporting is appropriate even though the regulatory agency may make the accountant's report a matter of public record.

59. The following report is illustrative of the type of report considered appropriate for a study based on pre-established criteria:

(Scope paragraph)

We understand that (recipient) has been awarded a grant of (amount) from (agency) for the period from (date) through (date) for use in accordance with the (title or description of program). We have made a study of those internal accounting control and administrative control procedures of (recipient) that we considered relevant to the criteria established by (agency), as set forth in (section) of its audit guide, issued (date). Our study included tests of compliance with such procedures during the period from (date) through (date). Our study did not constitute an audit of any financial statements prepared by (recipient).

(Explanatory paragraphs,
see paragraph 39)

(Concluding paragraphs)

We understand that procedures in conformity with the criteria referred to in the first paragraph of this report are considered by the (agency) to be adequate for its purpose in accordance with (name of act) and related regulations, and that procedures not in conformity with those criteria indicate some inadequacy for such purposes. Based on this understanding and on our study, we believe (recipient's) procedures were adequate for the agency's purposes, except for the conditions described (reference to appropriate section of report), which we believe are material weaknesses in relation to the grant to which this report refers. In addition to these weaknesses, other conditions that we believe are not in conformity with the criteria referred to above are described (reference to appropriate section of report).

This report is intended for the information of (recipient) and (agency) and should not be used for any other purpose.

Other Special Purpose Reports

60. An accountant may be engaged to issue a special report for the restricted use of management, another independent accountant, or other specified third parties, on all or a part of an entity's system of internal accounting control or proposed system of internal accounting control. For example, such reports may relate to *(a)* a study of system design without tests of compliance or *(b)* the results of applying agreed-upon procedures that are not sufficient for the purpose of expressing an opinion on the system taken as a whole.

61. The form of report in these circumstances is flexible, but it should (*a*) describe the scope and nature of the accountant's procedures, (*b*) disclaim an opinion on whether the system, taken as a whole, meets the objectives of internal accounting control, (*c*) state the accountant's findings, and (*d*) indicate that the report is intended solely for management or specified third parties.

Appendix

This Statement amends SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control,* paragraphs 1, 8, and 9 to read as follows:

1. This Statement requires the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards.* A material weakness in internal accounting control is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See SAS No. 30, paragraphs 31 through 34 for factors to be considered in estimating the amounts of errors and irregularities that might result from identified weaknesses in internal accounting control.

. . . .

8. The form of communication is optional. When the auditor communicates in writing, the suggested form of report is included in SAS No. 30, paragraphs 49 through 50. Because it is not practicable to communicate the varying extent of such studies in different engagements, these reports should be prepared for the restricted use of management, the board of directors, or its audit committee.**

9. If the auditor becomes aware of material weaknesses for which management believes corrective action is not practicable, he may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and related weaknesses is not required. When a written report is issued, the related sentence would state: "However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period, but management believes corrective action

*See also SAS No. 24, *Review of Interim Financial Information,* paragraph 10, which states: "If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should consider whether the weaknesses represent a restriction on the scope of his engagement sufficient to preclude completion of such a review. . . . The accountant should also advise senior management and the board of directors or its audit committee of the circumstances. . . ."

**However, when the study and evaluation made as a part of the audit is sufficient for expressing an opinion on the system, see SAS No. 30, paragraphs 37 through 46.

is not practicable in the circumstances." The auditor would then summarize the weaknesses and describe the circumstances (for example, inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel).

This Statement amends SAS No. 1, section 320.68, to read as follows:

The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion about whether the prescribed procedures and compliance therewith are satisfactory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness is a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes. If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control,* is required.

The Statement entitled Reporting on Internal Accounting Control *was adopted by the assenting votes of fourteen members of the board, of whom three, Messrs. Gotlieb, Mullarkey, and Williamson, assented with qualification. Mr. Berliner dissented.*

Mr. Berliner dissents to this Statement because of its definition of "weakness," which excludes cost-benefit considerations, and its prohibition against accountants expressing an opinion on management's cost-benefit evaluations.

Mr. Berliner believes that the definition of "weakness" is inconsistent with (*a*) the Statement's own expression of the broad objectives of internal accounting control, which he believes appropriately incorporates the notion of reasonable, but not absolute, assurance and (*b*) the provision of SAS 1, section 320.32, that "the concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived." Mr. Berliner believes accountants should not have to report a "weakness" if corrective action is not cost-benefit justified. This is particularly important because, in Mr. Berliner's opinion, the Foreign Corrupt Practices Act calls for a cost-benefit judgment before a condition is considered to be a violation; and, thus, requiring accountants to report weaknesses in a different sense could prejudice a client's contention that it has complied with the act.

Mr. Berliner believes that accountants are capable of making judgments about cost-benefit evaluations, which are at the heart of management's internal accounting control decisions, and they have been involved in doing so for years. By prohibiting an accountant from expressing an opinion on a cost-benefit statement by management under the circumstances described in paragraph 41, Mr. Berliner believes the Statement inappropriately restricts the exercise and expression of professional judgment.

Mr. Gotlieb approves issuance of this Statement but qualifies his assent because he disagrees with the requirement in paragraph 51 that the auditor issuing a report on internal accounting control based solely on a study and evaluation made as part of an audit distinguish between material weaknesses and other weaknesses that are not considered to be material. Mr. Gotlieb believes that this requirement effectively modifies SAS 20, which does not require such distinction, and that this modification is unnecessary for the limited use for which these reports are intended.

Messrs. Mullarkey and Williamson approve issuance of this Statement but qualify their assent because they disagree with the proscription in paragraph 41 that an accountant should not express any opinion on cost-benefit considerations relating to a material weakness reported by the accountant. They believe that an accountant has the professional competence to form an opinion about the relevant cost-benefit considerations, and that the accountant should be permitted or required to report both the control weakness and any related cost-benefit considerations because information about the separate elements would be of interest to those who would read the report.

Mr. Williamson also believes that the Statement creates a conceptually unexplainable gap between the definition of a material weakness, as revised by the Statement to make the definition compatible with the aforementioned proscription, and the definition of internal accounting control, as incorporated from SAS 1, section 320.28. Control continues to be defined in terms of providing "reasonable assurance" of achieving specified broad objectives, and the cost-benefit relationship continues to be the primary conceptual criterion to be considered in designing a system of internal accounting control. A material weakness, however, is now being defined without reference to reasonable assurance or to the cost-benefit relationship.

Auditing Standards Board (1979-1980)

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.*